No. 163

In the Supreme Court of the United States

OCTOBER TERM, 1945

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LAIRD WILCOX AND MAUD WILCOX

Brief of Respondents in Opposition to Petition for a Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit

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I.

There Is No Conflict Between the Circuits on the Question of Whether Embezzled Money Constitutes Taxable Income to the Embezzler.

The decision of the Ninth Circuit Court below, in the case at bar, *Wilcox v. Commissioner*, 148 Fed. (2d) 933, is not in conflict with *Kurrle v. Helvering*, 126 Fed. (2d) 723, (CCA 8th). The case of *Wilcox v. Commissioner*, *supra*, follows *McKnight v. Commissioner*, 127 Fed. (2d) 573, (CCA 5th).

In both the case at bar, *Wilcox v. Commissioner*, *supra*, and *McKnight v. Commissioner*, *supra*, the Circuit Courts found that the embezzler took the monies with no conceivable claim or colorable claim of right, and held them not as his own but as those of a third person, the monies at no time becoming a taxable gain or profit or income.

These holdings can not be in conflict with *Kurrle v. Commissioner*, *supra*, where the Court found, at page 724

of 126 Fed. (2d), that the embezzler had "treated said funds as his own" in a profitable enterprise. There is, in the latter case, a difference between the case at bar and the case of *McKnight v. Commissioner* by reason of the claim of right to the monies which the embezzler in the *Kurrle* case was found to have by the Court.

II.

The Rule Laid Down by the Supreme Court in North American Oil v. Burnet, 286 U. S. 417, Has Been Properly Applied in Determining What Is Income.

Although the case of *North American Oil v. Burnet*, 286 U. S. 417, did not involve embezzlement, the principle of that case laid down at page 424 of 286 U. S. has been rightfully used to determine what is income. The Court there said:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

That language has been relied upon by numerous Circuit Courts in determining whether money received constitutes income. The rule was applied in *Commissioner v. Turney*, 82 Fed. (2d) 661; *National City Bank v. Helvering*, 98 Fed. (2d) 93, at pages 95, 96; *Moore v. Thomas*, 131 Fed. (2d) 611, at page 613, and *Caldwell v. Commissioner*, 135 Fed. (2d) 488, at page 491. In the *North American Oil* case, the Court held that funds received or appropriated with a claim of right were taxable. The Circuit Courts have so applied the rule, asking in each

case whether the funds were received or appropriated with a claim of right, in order to arrive at the solution of whether the funds were income to the receiver or appropriator. Failing to find a claim of right, the Courts have consistently held, in accordance with the rule of the *North American Oil* case, that there was no income.

III.

Since the Embezzlement of the Property or Assets of Another Immediately Gives Rise to an Unqualified Liability and Duty to Restore to the Owner Thereof the Funds or Assets So Embezzled, or to Compensate Him Therefor, the Possession of Funds or Assets Acquired in Such Manner Does Not, Under the Constitution and Laws of the United States, Give Rise to Gains, Profits or Income Subject to Federal Income Tax.

Unlike illegal profits or gain from a business condemned by the penal laws, and, further, unlike profits or gain from business transactions held under a claim of right not theretofore adversely adjudicated and under circumstances that refund may yet be demanded, embezzled funds constitute no gain or profit.

Embezzled funds may be distinguished from other moneys in the following manner:

1. The embezzler gets no title to what he took.
2. The embezzler has no right or color of right to the funds.
3. The embezzler claims no right or color of right to the funds.
4. The embezzler incurs an equivalent debt at the time of taking.
5. There is no consideration of labor, services, merchandise or risk of capital by the embezzler.

We rely on *McKnight v. Commissioner of Internal Revenue*, 127 Fed. (2d) 572, and upon the better reasoning which is set out in that case. That case holds embezzled funds to be not taxable, inasmuch as they do not constitute gain or profit.

The Court in the *McKnight* case treats the embezzler as a debtor, and states (at page 573 of 127 Fed. (2d):

> "We find insuperable difficulties in the way of conclusion that one who embezzles funds entrusted to him realizes gain and receives taxable income thereby. Gain is very broadly defined, as to its sources, in the Revenue Acts, Revenue Act 1934, Sect. 22; Revenue Act 1936, Sect. 22(a), 26 U. S. C. A. Int. Rev. Code, par. 22. The classic definition of income is: " 'Gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets." Eisner v. Macomber, 252 U. S. 189, 40 S. Ct. 189, 193, 64 L. Ed. 521, 9 A. L. R. 1570. It does not appear here what the embezzler did with what he took, whether he realized any profit from its use or conversion, or even got any enjoyment by spending it. All we know is it is gone and he is left insolvent. Was gain realized by the act of taking? We think not. He got no title, void or voidable, to what he took. He was still in possession as he was before, but with a changed purpose. *He still had no right nor color of right. He claimed none. This the Board seems to concede*, and finds that the gain arose on his using the funds for his own purposes, whatever they were. The time of using, and not the time of taking, then would determine the incidence of the tax, and about that nothing is known. But when the entrusted fund is used, or even when taken with the purpose of dishonest use, *or even when taken with the purpose of dishonest use, the law immediately and absolutely fixes upon the embezzler the duty to account for and to repay the value of what is taken. By the taking the*

> *embezzler incurs an equivalent debt as surely as if he had borrowed with the consent of the owner.* The first takings are, indeed, nearly always with the intention of repaying, a sort of unauthorized borrowing. It must be conceded that no gain is realized by borrowing, because of the offsetting obligation. This would be true even though at the time there was no intention to repay. It seems to us that the same thing is true of each act of embezzlement. Commissioner v. Turney, 5 Cir., 82 F. 2d 661." (Italics supplied.)

There being an equivalent "offsetting obligation" as stated by the Court, there can be no taxable gain. Moneys received by way of loan do not constitute taxable income.

William G. Stayton, Jr., 32 B. T. A. 940;
Carl G. Fisher, 7 B. T. A. 968.

It has heretofore been argued in other cases that borrowed money is not converted into income if the borrower spends the money for his own pleasure. So, too, embezzled money is not income by being spent, there existing in both cases an unqualified duty and obligation to repay the same.

And under the principle involved, there can be no difference whether the money was legally borrowed or illegally taken. In both cases, the duty to repay immediately impresses itself upon the funds, offsetting any concept of gain or profit.

We have stipulated with counsel for the Commissioner that the money embezzled is still due the rightful owner and that it always has and now does hold the taxpayer liable to restore the same. (See part (k) of Stipulation of Facts (R. 12-13). Thus, there is in the instant case an

established creditor-debtor relation between the embezzler and the rightful owner.

We have listed five ways which distinguish embezzled funds from other moneys. We think there can be no dispute with the first, that the embezzler gets no title to what he took; nor with the second, that the embezzler has no right or color of right to the funds; nor the third, that the embezzler claims no right or color of right to the funds; nor, as we have illustrated, that the embezzler incurs an equivalent debt at the time of taking. As to the fifth distinguishing feature that the embezzler risks no capital and gives no labor or services, we think clearly makes embezzlement cases unique from all others. In the cases of illegal profits from businesses in violation of the law, there is clearly consideration for labor or capital and a gain on the labor or capital risked. In all other cases there is some transaction or deal between the taxpayer and the one from whom he obtains the money. There is some labor or service performed or some capital risked.

As an instance, let us take the case of *Humphrey v. Commissioner*, 125 Fed. (2d) 340, where $50,000 in ransom was held to be income. There, the illegal holding of a human being caused a business transaction, however illegal in itself, to arise. There was consideration, no matter how wrongful, for the payment of the money. There was *a claim of right* to the money as consideration for delivery of the body of the kidnapped victim.

Again, in *United States v. Wampler*, 5 Fed. Supp. 796, an attorney was held taxable on income constituting money which was given to him to settle a case and per-

of which he retained after settling the matters for less than the amount delivered to him. The Court held that the act was not embezzlement. (See p. 798 of 5 Fed. Supp.) The attorney had clearly given some services as part of the consideration. The money was delivered to him in a business transaction in which he was to give some services.

IV.

Money Taken Through Embezzlement Is Not Taxable Gain and Is Distinguished From All Other Illegal Acquisition Which Arises From Unlawful Business Transactions.

We concede that illegal profits and illegal gains are income. It is well settled that actual gains or profits may not be excluded from taxable income, merely because realized from activities or business condemned by penal statutes. As for instance:

Taxing the income of a bootlegger from the illegal sale of liquor.
United States v. Sullivan, 274 U. S. 259.

Including in income "commissions" received from road construction company.
Chadick v. United States, 77 Fed. (2d) 961.

Gain from the purchase of sweepstake tickets.
Christian H. Droge, 35 B. T. A. 829.

Race track bookmaking.
Jas. P. McKenna, 1 B. T. A. 326.

Card playing.
L. Weiner, 10 B. T. A. 905.

Unlawful insurance policies.
Patterson v. Anderson, 20 F. Supp. 799.

Illegal prize fight pictures.
George L. Rickard, 15 B. T. A. 316.

In these cases actual gain can be computed, and the money is not recoverable from the taxpayer by those who paid him.

We further concede that gains and profits received by a taxpayer and held by him under a claim of right not theretofore adversely adjudicated or denied by settled law, may be taxed to the recipient, although earned or received under *such circumstances that third persons could have demanded an accounting from the taxpayer for all or a part thereof.*

Such cases are well known:

Secret profits realized by a director of a corporation from dealings in the property of the corporation.

City National Bank of N. Y. v. Helvering, 98 Fed. (2d) 93.

Profits openly earned by an officer of a corporation but at the expense of the corporation.

Board v. Commissioner, 51 Fed. (2d) 73.

Usurious interest actually collected.

Barker v. Magruder, 95 Fed. (2d) 122.

Income of an attorney from the settlement of claims for less than the amount advanced to him for such purpose by his client.

United States v. Wampler, 5 Fed. Supp. 796.

Excessive commissions or bonuses to corporate officers.

Saunders v. Commissioner, 101 Fed. (2d) 407.

Excessive tariff charges.

Chicago, R. I. & P. Ry. v. Commissioner, 47 Fed. (2d) 990.

Dividends on stocks prematurely distributed.

Ford v. Commissioner, 51 Fed. (2d) 206.

It must be remembered that in all the last cited cases there was a *business transaction* and a holding under a *claim of right*. Further, no adjudication of the duty to return had been made or denied by settled law.

It will be readily found, as said in the case of *Moore v. Thomas*, 131 Fed. (2d) 611, at page 613, that money obtained by embezzlement is a case of "special circumstances." In deciding against petitioners in that Court, the Tax Court rested its opinion "on the authority of Estate of Thomas Sprunance, Kurrle v. Helvering and Humphreys v. Commissioner" (R. 20). The first case, *Estate of Thomas Sprunance*, 43 B. T. A. 221, was actually the *McKnight* case, reversing *Sprunance* on appeal (127 Fed. (2d) 572). The case of *Humphreys v. Commissioner* does not involve embezzlement, but, as we have hereinbefore illustrated in this brief, is a case of an illegal business transaction with a claim of right to ransom money by a kidnaper, upon delivery of the body of the victim. Thus, only one case, *Kurrle v. Helvering*, supra, involves embezzlement, and that case does not follow the theory of the law of embezzlement that there is an immediate obligation of the embezzler in law to repay which offsets any concept of income, gain or profit.

V.

Local Law Must Determine Whether the Taking Was Without a Claim of Right From the Time of the First Appropriation.

In its decision, the Circuit Court below (Wilcox v. Commissioner, 148 Fed. (2d) 933), applied the local law of the State of Nevada where the alleged embezzlement took

place to ascertain whether there was an immediate offsetting obligation. At page 934 of 148 Fed. (2d), the Court said (R. 32):

> "[1] The crime of embezzlement in Nevada is complete when the embezzler "use[s] or appropriate[s] such money * * * in any manner, or for any other purpose, than that for which the same was * * * intrusted." State v. Trolson, 21 Nev. 419, 425, 427, 32 P. 930, 931. Here the record shows that the appropriation for gambling purposes occurred at the taking of the moneys.
>
> [2, 3] Under the law of Nevada the employer here could have replevined the embezzled moneys in the possession of the embezzler as soon as he appropriated them. Sec. 8681, Nevada Compiled Laws, 1929; Perkins v. Barnes, 3 Nev. 557; Studebaker Co. v. Witcher, 44 Nev. 568, 471, 199 P. 477, 201 P. 322. Also under the Nevada law an embezzler is liable to the party from whom the property is appropriated for an amount equal to its value. This is so whether after appropriation the moneys are hid in a basement or used in gambling. The use in no way transfers the property right of the owner in the moneys."

Nevada statutes further provide that embezzled property may be summarily restored to its owner by a magistrate. *Nevada Compiled Laws, 1929, Sections 11243-11246.* Hence, under local law, in view of the stipulation of facts (R. 9-13) that the funds were embezzled, no title to the funds could have passed to the embezzler, and it is apparent that (1) no claim of right did or could exist, and (2) the obligation of the embezzler set-off and counterbalanced any conception of gain, income or profit.

VI.
CONCLUSION

WHEREFORE, it is respectfully submitted that there is no conflict between the Circuit Courts of Appeal upon the question of whether embezzled money constitutes income to the embezzler. Furthermore, the test adopted by the Circuit Courts in applying *North American Oil v. Burnet*, supra, to determine whether there is a claim of right is a judicious and accurate legal analysis for definition of income, gain or profit under Section 22(a) of the Internal Revenue Code. There being no conflict between the Circuit Courts and the application by said Courts of the law being in accord with the Supreme Court's rule of decision, the petition for certiorari should be denied.

Respectfully submitted,

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Reno, Nevada, August 31, 1945.